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A Guideline to Orderly Debt Restructurings: With Special Reference to Lebanon

Abstract

*There is no international framework or sovereign law today that forces any country to **undergo a** debt restructuring or resort to the IMF when in crisis*[1]*. In fact, to-date there is no "bankruptcy" law(s) or framework that governs a "defaulting" sovereign (Lastra et al., 2014 & 2016).*

Lebanon's crisis is multi-faceted and the option of a debt restructuring remains unclear to the public. The study aims to academically address the current option of an "orderly" Debt Restructuring for Lebanon. It relies on the work of academicians and practitioners who have been rigorously studying & drafting a modern "policy framework for a sovereign debt restructuring and/or default" at least since 2001.

In details, the study will define what a debt restructuring is, explore its main theoretical framework (i.e. the literature for readers interested to further investigate sovereign debt crises), dissect the link between the IMF, Lebanon & the Debt Restructuring Process, and portray the cost burdens attached to an orderly restructuring v/s a "messy default" at this focal point of the Lebanese Crisis.

I. Sovereign Debts: Insolvency or Default of the State

By definition, a state lacking the means to pay back its debt when it is due is considered "*insolvent*". Buchheit (2002) explains that a borrowing transaction involves a Debtor (country) and Creditors (i.e. lenders). Therefore in a typical sovereign debt workout scenario, the debtor's resources are insufficient to pay all Creditors the full amount owed on scheduled maturity dates. Picarelli & Niemminen (2017) define 'sovereign solvency' as the country's "*future ability to repay debt*". They clarify that 'solvency' is particularly pressured by eminent increases in public debt i.e. servicing that debt takes up a large chunk of GDP and limits the government's scope to

[1] Any sovereign must be a "member of the IMF's 189 member- countries" , to have the right to resort to their rightful quota from the IMF funds, in its time of need if authorities claim/request access.

implement its political program. In addition, Wood et al. (2010) conclude that there isn't a clear-cut or legal definition for "*sovereign insolvency*". Yet, Wood's work explains that a country's "insolvency condition" exhibits 4 signs:

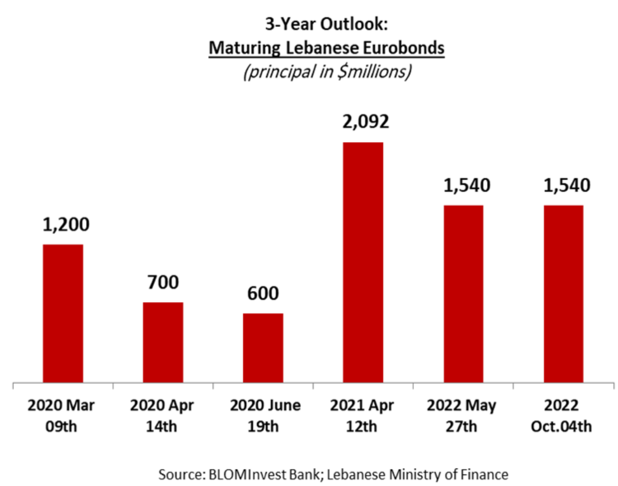
1. A triggered default on the sovereign's bond issues (and/or bank loan agreements).
2. Credit rating agencies consider downgrading the state's ratings.
3. Actions by these credit agencies risk lessening the nation's ability to raise new finance.
4. Such downgrades may also trigger increasing banks' required capital.

Woods adds that a nation's "inability to repay" is usually linked to foreign currency obligation[2]. In fact, Foreign Assets[3] (FAs) at the central bank (like BDL's) are of utmost importance. They basically help the government settle all transactions conducted between the country and the rest of the world. They also help maintain the official exchange rate or peg and ensure the import of essentials (fuel, wheat, meds). FAs safeguard financial and economic stability because they ensure the sovereign can make payments and repayments in foreign currency, in perpetuity.

II. Sovereign Debt as Applied to the Lebanese Reality

The 4 symptoms of "insolvency" actually materialized in Lebanon. Since mid-October 2019 to-date, the use of FAs to import essential goods and service Lebanon's twin deficits alongside the imposition of capital controls left the authorities and central bank in a serious quagmire[3].

The Ministry of Finance cannot issue new debt instruments or 'reward enough coupons', let alone convince new buyers of subscribing to "junk"-rated investments. Consequently, Lebanon's Creditors now question the country's ability to repay the existing debt it owes, i.e. they expect it "to default on its due payments" as we stand less than 1 month away from maturing $1.2B Eurobonds (in principal) that are owed to international and national bondholders.



Increasing Lebanese banks' required capital was also triggered while banks were downgraded. In November 2019, Banque du Liban (BDL) issued new Circular No.532 instructing banks to increase

[2] This holds true if we assume that the state can always print more of its own money (to a certain extent) without igniting inflation and hurting the economy), to pay back its debt denominated in national currency.

[3] Central banks like BDL for instance, replenish Foreign Assets (FA) mainly from expatriates' deposits at Lebanese banks. But, when Foreign Assets are directly or indirectly used to service substantial debts i.e. twin deficits (the fiscal and current account's) and capital controls halt new capital inflows, FAs at the very least stop growing while part of them is used to import essentials of medicine, wheat, fuel oil into the country.

Tier I Capital by a total of 20% by June 2020. Shortly later, S&P downgraded Lebanon's foreign and local currency issuer credit ratings to "*Selective Default*" on 3 Lebanese Banks (one of which was retracted). S&P further explained, "*[…] private individuals' lack of access to their bank deposits on time and in full […] and constraints to their ability to transfer funds abroad constitute a risk for depositors of losing the benefit of their agreements and therefore a selective default […]*" (S&P on Lebanon, Dec. 2019).

Lebanon's long-term foreign currency Issuer Default Rating was also downgraded by Fitch Ratings from CCC to "CC". A "*government debt restructuring or default is probable owing to acute political uncertainty, de facto capital controls and damaged confidence in the banking sector that will deter capital inflows needed for Lebanon to meet its financing needs*" (Fitch on Lebanon, Dec. 2019).

There is *No magic wand to make it all disappear* because the costs are high under all scenarios. We may choose to default on our upcoming maturing debt (Eurobonds on March 09th), or to restructure & reform. Yet, the IMF's First Deputy Managing Director Anne Kruger (2002) explains that the absence of a mechanism for debt restructuring "*can lead a sovereign with unsustainable debts to delay seeking a restructuring, draining its reserves and leaving the debtor and the majority of its creditors worse off*". Numerous nations, experts and global institutions (IMF, World Bank) were engaged in the resolution of acute sovereign crises and worked on policy frameworks or mechanisms to attenuate a similar "national mess". But all stakeholders do not go unscathed. That said, with the right discussions and collaborations, **we can draw an orderly** action plan to resolve Lebanon's quagmire, starting with the unsustainable debt draining on Lebanon's foreign reserves.

III. Debt Restructuring & Application to Lebanon's Debt

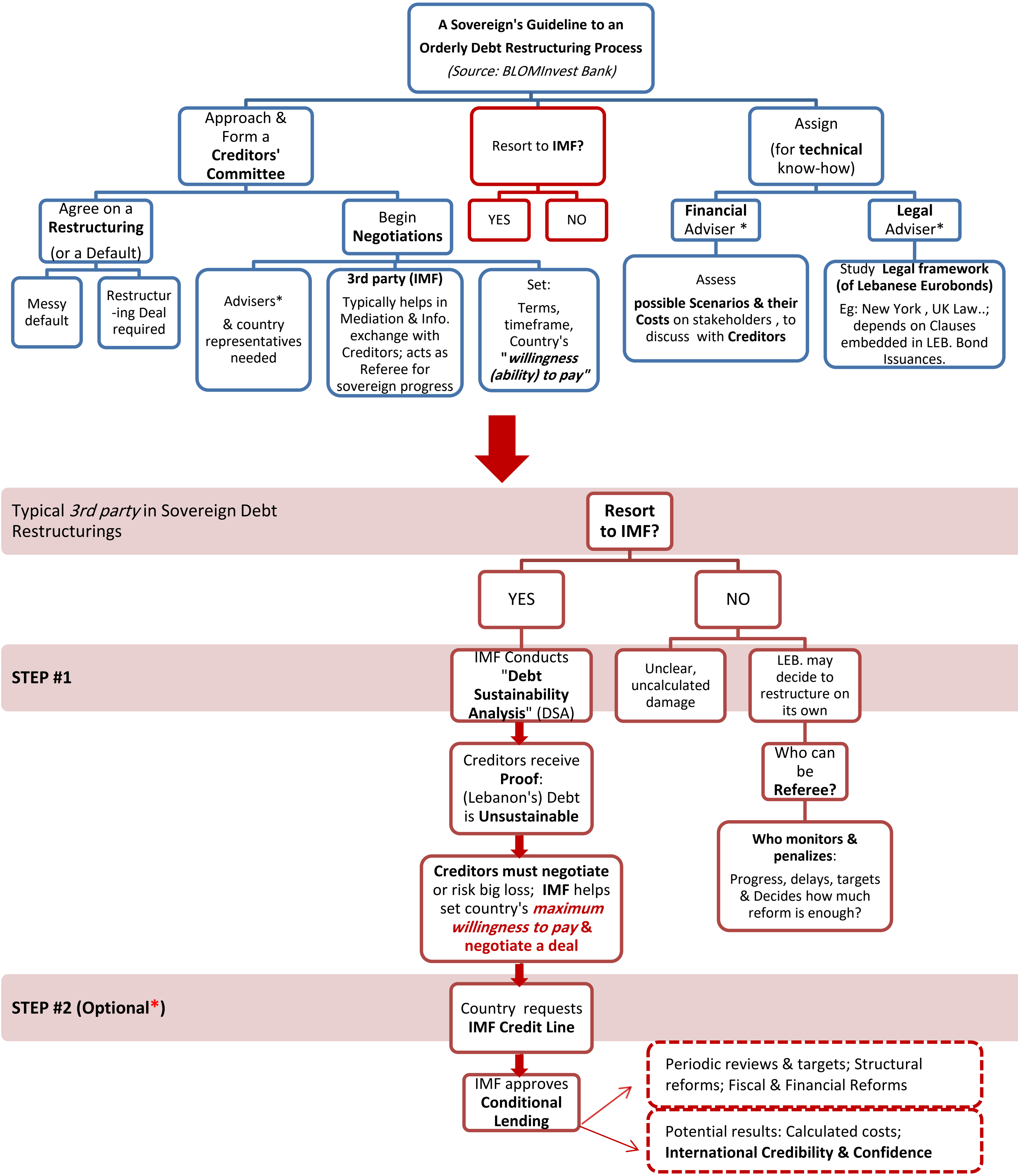
In a nutshell, a "debt restructuring" is the adjustment of a debt via a legal process. When a sovereign is highly indebted and lacks the means to pay-back its lenders or make timely repayments, it exhausts its policy-tools (reform agendas) for years, attempting to restore financial and economic stability. Yet when these methods consistently fail, the country has 2 options: a) to restructure or b) to default. A "sovereign restructuring mechanism" may be initiated to minimize the costs incurred by a default scenario. A restructuring usually involves an agreement among involved parties (stakeholders) by which the debtor (sovereign) seeks to secure a more feasible arrangement with its creditors to meet its financial obligations.

A restructuring usually involves key stakeholders but is governed by one principle: Equitable burden-sharing. A debt restructuring requires: *Time, Orderliness, Effort, Coordination, Negotiations, Accountability, Transparency and Compromise* from all Stakeholders, especially given that "*there is no international bankruptcy court nor a transnational sovereign bankruptcy regime or code [similar to the USA's Chapter 11] that could permit sovereign borrowers to obtain debt relief when their financial obligations outstrip their ability to pay without worrying about hostile creditor actions[…]"* (Serrano & Lastra, 2016) (Krueger & Hagan, 2005). Moreover, it is crucial that the debt workout strikes the right balance among the 3 stakeholders to establish an equitable "*burden-sharing*" (Buchheit, 2002) of costs and benefits, attenuating uncalculated outcomes on the country's social fabric and hostile legal actions triggered by creditors.

A "debt restructuring" proposition (like Lebanon's today) has 3 purposes that help define its 'success'. Restructuring a sovereign's debt does not happen overnight. It is a lengthy, detailed process composed of different phases and it is likely to be "successful" when it helps achieve 3 main purposes:

1. **Make the default less messy, more orderly**. This means proper decisions on *which creditors to upset/prioritize, how many of them*, or *by how much*. This is important because a restructuring still reduces the NPV, so the aim is to minimize costs and maximize benefits.
2. **Ensure the debtor country will have future "market access".** Most literature shows that countries which demonstrate maturity towards a foreseen default succeed in 'politely' demanding a well-structured default from Creditors. This reveals to international bond markets later that the sovereign responsibly managed Creditor negotiations. This orderly achievement goes a long way, also knowing that 21st century international bond markets have gone a long way in terms of bigger pools of funds for sovereign borrowing and risk-avid lenders.
3. **Reduce unintended & unknown costs while boosting the country's '*good faith*' efforts.** An orderly, well-managed restructuring can reveal the "*good faith*" of the country (Buchheit et al., 2018) (IMF, 2013). The collaborative agreement reached thus gives the sovereign a 'best shot' at accessing future potential international financial markets.

Figure 1.



A Sovereign's Guideline to an Orderly Debt Restructuring Process
(Source: BLOMInvest Bank)
Approach & Form a Creditors' Committee
Resort to IMF?
Assign (for technical know-how)
Agree on a Restructuring (or a Default)
Begin Negotiations
YES
NO
Financial Adviser *
Legal Adviser*
Messy default
Restructur-ing Deal required
Advisers* & country representatives needed
3rd party (IMF) Typically helps in Mediation & Info. exchange with Creditors; acts as Referee for sovereign progress
Set: Terms, timeframe, Country's "willingness (ability) to pay"
Assess possible Scenarios & their Costs on stakeholders , to discuss with Creditors
Study Legal framework (of Lebanese Eurobonds) Eg: New York , UK Law..; depends on Clauses embedded in LEB. Bond Issuances.
Typical 3rd party in Sovereign Debt Restructurings
Resort to IMF?
YES
NO
STEP #1
IMF Conducts "Debt Sustainability Analysis" (DSA)
Unclear, uncalculated damage
LEB. may decide to restructure on its own
Creditors receive Proof: (Lebanon's) Debt is Unsustainable
Who can be Referee?
Creditors must negotiate or risk big loss; IMF helps set country's maximum willingness to pay & negotiate a deal
Who monitors & penalizes: Progress, delays, targets & Decides how much reform is enough?
STEP #2 (Optional*)
Country requests IMF Credit Line
IMF approves Conditional Lending
Periodic reviews & targets; Structural reforms; Fiscal & Financial Reforms
Potential results: Calculated costs; International Credibility & Confidence

We must distinguish between a "Pre-emptive" or "Post-Default" restructuring to have a better grasp of the choices ahead of Lebanon today. By definition:

1. Pre-emptive restructuring
    - The sovereign debtor is in trouble and requests a restructuring from its creditors well before the maturity date of its debt.
    - Quicker to complete and secure higher creditor participation, as some literature shows.
    - Usually it aims to tackle a liquidity crisis in the sovereign.
    - Faster access to international capital markets, as per the empirical evidence.

***In reference to Figure 1. above (page 5), the decision to resort to the IMF (a 3rd party) is critical.** "*If authorities come very late to the IMF for financial assistance and have run out of funding, it may not be feasible to execute a pre-emptive debt restructuring ahead of a Fund arrangement.*" In fact, "*debt restructurings have often been too little and too late, thus failing to re-establish debt sustainability and market access in a durable way*" *(IMF, 2013)*.

Lebanon's potential "pre-emptive restructuring" for example in reference to Fig.1, risks coming *too late* if further delayed. That is, if Lebanon opts for a pre-emptive restructuring i.e. making its principal and interest payments on March 09th 2020 whilst committing to a serious reform agenda, then it is not obliged to get into an "IMF program" because it did not "default". However, come March 09th and Lebanon does not make its payments, it falls into arears and resorting to the IMF could thereby place Lebanon under a structural program to obtain the IMF's conditional lending as stipulated in its "Lending into arears[4] policy".

2. Post-default restructuring
    - The sovereign has defaulted on payments that were due.
    - Usually aim to tackle a **solvency crisis** in the sovereign.
    - Usually lengthier, and may reveal creditor holdouts, as some literature shows.
    - May entail larger haircuts;
    - Reputation may be stained indefinitely while the country's debt also remains side-lined indefinitely in the market.

In the context of Fig.1, it is worth noting that the IMF's Debt Sustainability Analysis (DSA) makes it a central player in a restructuring process. The decision to opt for a debt restructuring is usually triggered by a sovereign with "*unsustainable*" debt. As per the IMF definition, a country's debt becomes "unsustainable" when "*there is not a realistically feasible set of economic policies, short of a miracle, that are likely to be politically sustainable, that offer prospect of allowing the member to regain viability [...]"* (IMF, 2002 & 2003). From here, the IMF's DSA plays a central role

[4] "*device to legalize the IMF's lending in presence of external private arears*" (Erce, 2013).

in deciding whether the country needs/does not need a debt restructuring, regardless if the restructuring occurs in the context of an IMF-supported adjustment program[5], or outside of it.

The IMF generally favours engagement with creditors in a "restructuring process", even though sometimes its intervention becomes more prominent. The institution encourages the collaborative agreement between a debtor and its creditors via the advisers hired by the indebted state. However, "*The hand [which] writes the [structural program, inclusive of the sovereign's conditioned lending], rules the restructuring*" (Buchheit, 2002). This is to say that in "pre-emptive restructuring (pre-default)" scenarios, the IMF tends to leave the negotiations' specifics to the debtor. Nevertheless, the IMF's role may prove more prominent in "post-default cases" when the IMF, guided by its "Lending into arears" policy, sets specific standards for the negotiations and tends to assess the sovereign accordingly. (More on the IMF role in the next section)

When a restructuring is agreed upon, debtors and creditors must agree on the forms of debt reduction (alleviation) accepted by both. These forms include: *Haircut* (forgiveness of principal); *Coupon adjustment* (forgiveness of interest); and *Rescheduling* (Krugman, 1988). The first two basically decrease the nominal value of outstanding existing debt. According to Picarelli (2016), when the amount of debt outstanding is too large, it is wiser to reduce the nominal value of the debt to appease the costs on creditors and the debtor alike. In fact, applying Myers's (1977) theory of debt overhang[6] to sovereigns with large debts shows that the reduction of nominal value via a haircut for example is the most efficient option for both creditor and debtor in terms of "*restoring incentives to invest*". *Picarelli* believes lengthening maturities may become a process that exacerbates the debt overhang, as it postpones the solution of the real problem (the actual debt) and fails to eliminate the deterioration possibility of the borrower's financial conditions and repayment capacity.

Restructuring or defaulting on debt comes at a cost, so an orderly restructuring may help maximize outcomes and contain costs. Buchheit et al. (2018) believe that "*all sovereign debt workouts are painful - for the debtor country, its citizens, its creditors, and its official sector […].*" For that reason, "the *capital markets will remember whether the debt workout process was conducted efficiently and fairly […].*" The main benefits/costs of a restructuring are:

a) Reputational risks:

A country conducting a restructure may face "market exclusion" or "borrowing costs". The former means creditors may "punish" the sovereign by not purchasing its bonds, while the latter involves creditors requesting a premium to compensate for the risk of a potential default or another restructuring in the future. However, the process of a sovereign debt restructuring is

[5] Also known as a Credit Line or a structural program. All these terms can be used interchangeably to describe the country resorting to IMF financial assistance or lending service.

[6] "*A country has a debt overhang problem when the expected present value of potential future resource transfers is less than its debt*". (Kruger, 1988)

based on 2 prime assumptions which play the eminent role in the harm done to the country's reputation:

- Creditors need to be convinced that the debtor will address its structural problems, and
- Regardless of how "generous or forgiving" any creditor may be, no one class of creditors is capable of restoring to the debtor sovereign its debt sustainability.

b) Market access (or lack thereof):

Once a country is "defaulted", it risks facing a full and enduring buyer strike and unknown collateral damage to the national financial sector and the real economy. According to Picarelli & Nieminen (2017), creditors may even prefer a restructuring scenario over a default because a "deal with the d*ebtor [would secure] a [mutual] agreement on the new amount of and conditions for debt reimbursement, which may lead to higher returns compared to a default option.*"

c) Litigations & breach of service contracts:

Despite agreeing on a restructuring scenario, Creditors suffering a reduction in NPV will seek their best interests, the reason why being 'orderly' can prevent/reduce legal actions against the sovereign. According to Krugman (1988), "*it seems obvious that the creditors are not likely to collect the full potential resource transfer from the country if there is a disorderly default".*

d) Other main costs:

Market exclusions, trade embargos, reputational costs (like Argentina's litigations saga, 2001) and sanctions may burden a country's economy and stature in international markets. Debtor states, like Lebanon for instance today, may also fear a *"[…] financial and political fallout […] if the domestic financial sector held a significant amount of public debt*" (IMF, 2013).

IV. Role of the IMF and the Lebanese Decision

Initially, the IMF is mandated to assist sovereigns in temporarily mending balance of payments (BOPs). The IMF role is to assist countries during BOP imbalances, to allow them to continue servicing their debt, repay the IMF and ensure future international market access. Therefore, the IMF usually indicates, "*what budget savings the country could achieve, which implied a financing gap to be filled by new lending and debt relief from other creditors*" (Buchheit, 2005). A typical IMF program offers financial support to the country for up to 3 years, conditioned on economic reform and -when/if needed- also conditioned on a restructuring of the sovereign's debt.

However, the IMF went from temporarily supporting countries' BOP crises to a "*crisis manager*" today. Historically, countries faced crises while sovereign borrowing grew. When debts became too big to repay, several international players namely the IMF, intervened to manage the restructurings and safeguard the global economic and financial stability. However, improving the crisis management toolkits and handling debt restructurings is an on-going process. Legal and financial professionals have also highlighted several flaws in the IMF's sovereign assistance over the years. Yet, the entity is in constant evolution especially since the 2001 Argentina debt litigations and the 2008 global financial crisis which triggered sovereign debt crises in the Eurozone.

The main IMF roles in a debt restructuring process are:

- Facilitator in the Decision-making process & advisory role. i.e. helps the sovereign take the decision to restructure and what is the best course of action to minimize costs.
- Incentivize stakeholders of the restructuring process to participate and minimize possible holdout creditors and litigations attached to them.
- Inter-creditor coordination & Information provider: the option to restructure usually emerges when the country is facing a crisis while its resources are jeopardized. During such times, it is evident that uncertainty and asymmetry are heightened and a well-equipped mediator can help mend data gaps.
- Set the "resource (financial) envelope" of the restructuring, i.e. identify the resources available to anchor the Debtor-Creditors negotiations and restructuring proposition(s).

However, IMF intervention in modern sovereign crises remains flexible. The international community and the IMF exhibited greater devotion to debt restructurings. When a country's debt burden is judged unsustainable, the intervention of an international institution like the IMF may help the sovereign regain viability. However, it is crucial to understand that the IMF intervention remains flexible and the reform progress (or lack thereof) depends on internal and external country-specific factors as well.

Lebanon's policy-makers, official sector and the society at large have begun to recognize that Lebanese debt is unsustainable. In light of the explored basic definitions and guidelines in this paper, it is fair to conclude that taking "too long" to decide on a) defaulting or b) restructuring when debt is unsustainable in an economy diagnosed with all symptoms of a sovereign debt crisis is very costly for the sovereign on the macroeconomic and country reputation fronts. Therefore, Lebanon today must immediately initiate a framework to manage the debt and simultaneously implement a set of adequate policies to help restore "debt sustainability". Doing so may help limit the economic and moral damage and enhance authorities' transparency vis-a-vis its citizens as well as the international community, its future creditors. This is where the importance and criticality of a prompt decision regarding Lebanon's payment (or non-payment) of maturing Eurobonds comes to the forefront.

V. Conclusion: Some Lasting Observations Relevant to Lebanon

- Evidence shows that a liquidity crisis – in the sense of not being able to pay short-term interest and principal on external debt or debt denominated in foreign currency – occurs when short-term debt exceeds 130% of reserves; whereas a solvency crisis occurs when external debt exceeds 50% of GDP (Manasse and Roubini, 2009). Given that the short-term external debt to reserves ratio is only 16%, and the external debt to GDP ratio is 55%, then the warning sign indicates that Lebanon's is a crisis of solvency.

- **This calls for the need to restructure debt.** If Lebanon elects not to default and pay its short-term obligations, then its option is to undertake pre-emptive restructuring. However, if it elects to default on its short-term obligations, then it would have opted to undertake post-default restructuring. Each has its pros and cons, as outlined in the paper above. Most crucially, the arrears incurred from default could involve a structural program with the IMF under its "Lending into Arrears" policy.
- **A very important consideration to take into account is burden sharing**. Domestic debt (or debt denominated in local currency) is no doubt easier to restructure because it is under local jurisdiction, but 25% of Lebanon's domestic debt is held by banks and 55% by BDL (the rest by local financial institutions). As for foreign debt, 50% is held by Lebanese banks, 20% by BDL, and 30% by foreign institutions. It is apparent then that, with Lebanese banks holding 75% of total debt, any restructuring scheme should not involve a heavy burden on banks so as not to turn the sovereign debt solvency crisis into a banking solvency crisis.
- **Naturally, the foreign debt crisis involves considerable cost.** Evidence shows that it leads to higher borrowing costs and to exclusion from international capital markets, at least for the first two years after default (Ams et al, 2018). It is also associated with a reduction in GDP growth by 2% to 6% in the first year – higher if default is accompanied by banking crisis; a 7% fall in trade per year for about 10 years and so is a 2% fall in FDI as a percentage of GDP; in addition to large drops in the value of firms on domestic stock markets and to considerable falls in private credit. So it would be wise – both economically and socially – for the government to devise redemptive policies to soften the impact of these negative implications.
- On the other hand, and on the positive side, restructuring periods in developing countries are associated with a notable drop in total public debt to GDP by over 30%, as well as an even stronger decline in the ratio of total external debt to GDP by more than 40% (Das et al, 2012). The ratio of external short-term debt to reserves also shows a steep drop by more than 50% and just in a single year. Moreover, macroeconomic conditions also improved post restructuring. Real growth was only around 1.5% three years before final agreements, but stayed consistently above 4% during the three years following the exchange. In a similar vein, inflation decreased from around 20% three years before restructuring to just 7.5% or less three years after restructuring.
- **In this context, it is essential to avoid repeat restructuring.** Repeat restructurings suggest that a one-time restructuring was often not enough to solve the debt problem. For example, of the 44 countries that restructured with private foreign creditors between 1980 and 2012, two-thirds did not successfully establish sustainability and led to repeat restructurings. Moreover, there is evidence that countries in a situation of chronic debt overhang tend to meaningfully grow again only after significant debt relief agreements involving face value reductions were implemented. Hence, it is more efficient and less

troublesome if the government overcomes the trap of repeat restructuring and goes for a "one-and-done" approach.

- **Lastly, a major obstacle to resolving debt crises is the coordination problem among a large and dispersed group of bondholders.** Individual investors have an incentive to free-ride, rejecting the haircut suffered by other creditors, and possibly going to court, resulting in less debt relief and the risk of disruptive litigation – the well-known "holdout problem". In this respect, evidence shows that a one-standard-deviation increase in haircut size (25 percentage points) is associated with a 9 percentage point higher holdout rate (Fang et al (2018). In addition, smaller bonds (low outstanding amount) bonds issued under foreign-law (such as New York or English law), bonds with high coupons, and more actively traded bonds (those with regular prices on Bloomberg) see lower participation rates. These results are very relevant for the government to know which bonds could become a target for strategic holdout investors in a sovereign debt restructuring. And, finally, in case some Lebanese bonds were issued with Collective Action Clauses (CACs), these can help reduce final holdout rates by between 10% and 20%.

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